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February 21, 2001 **LETTER 1314**

February 2, DJIA 10864.10; PTI 5239; A-D Ratio –3.71
February 9, DJIA 10781.45; PTI 5234; A-D Ratio –3.67
****February 15, DJIA 10795.41; PTI 5236; A-D Ratio –3.43**
***Dow Times Book Value: 6.58 **early to press = Thurs. close**
***Percentage of Undervalued Blue-chips: 14%**
***Gold 34-day MA: 267 Dow yield: 1.63; Dow p/e: 22.2**

THE PICTURE: Sentiment among professionals is changing rapidly. The change is that many previous bears are now turning bullish. Some are even sheepish about turning bullish, and are offering excuses such as "the Fed made me do it," or "breadth is too good for this to be a bear market."

I put **values** above all other considerations, and current values are still characteristic of a bull market top rather than a bear market bottom or the reviving of the old bull market.

The veteran *Lowry's* service starts its February 9 report, "We continue to hear from seasoned professional investors that this is one of the most frustrating periods in many years." *Lowry's* explanation is that "most of the major price indexes are composed primarily of growth stocks, which are currently out of favor with investors. On the other hand, there are very few broadly accepted indexes composed of value stocks which are currently very much in favor with investors. It is, to a large extent, the value stocks and the interest-sensitive stocks, that are dominating the list of stocks making New Highs."

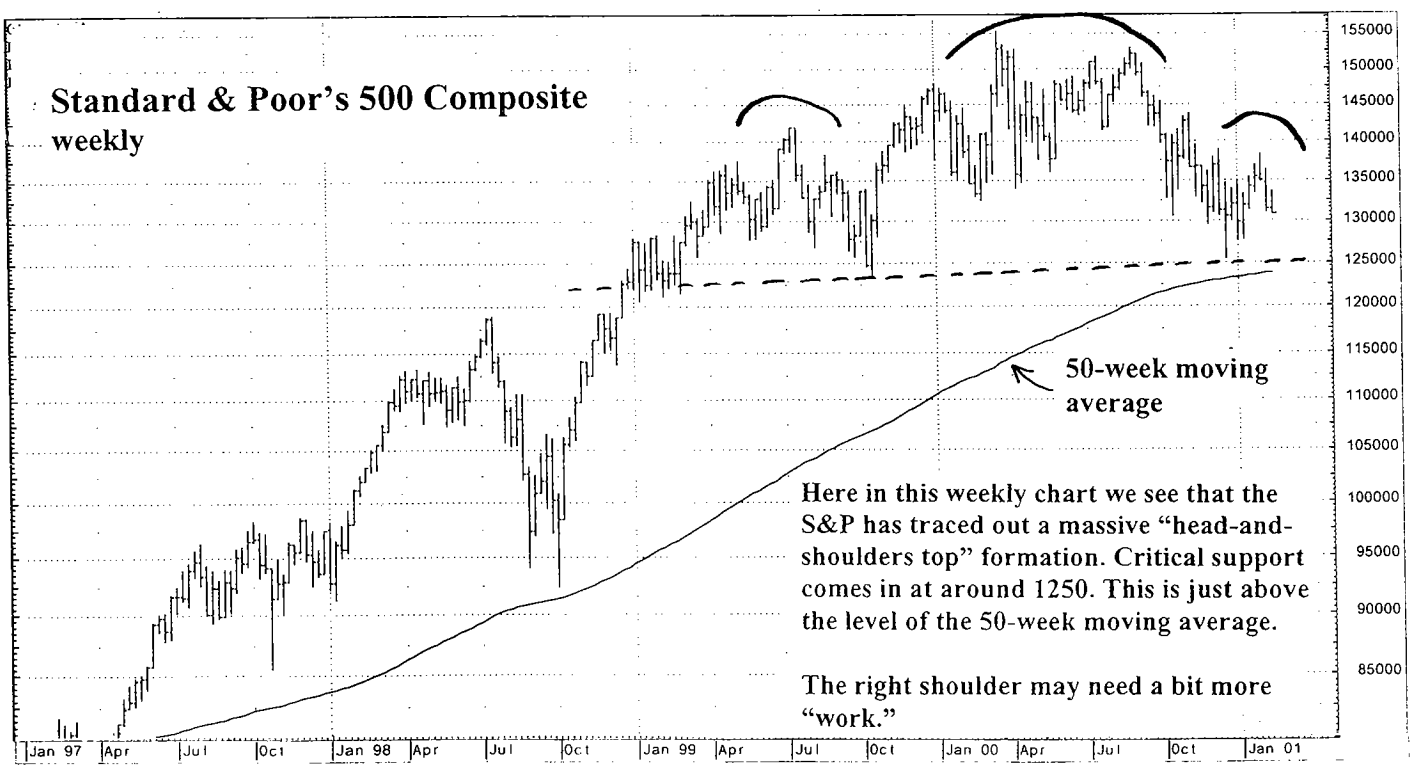
I won't argue with any of the above. My own inclination is to step aside from today's overvalued stocks (except for utilities) and compound my money in tax-free municipal bonds. I've said all along that this would be a bear market of attrition and I added that the Fed is going to prolong the bear market by fighting it with all the ammunition at its command.

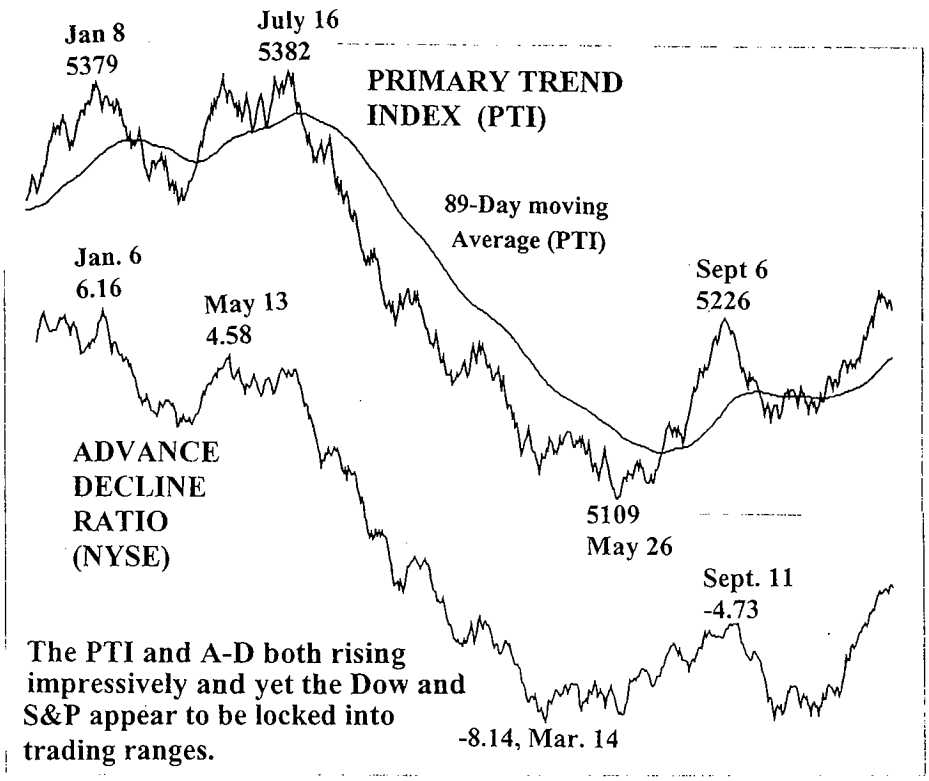
In the end, the Fed will lose, simply because the Fed, by its actions, will "float" inefficient corporations and methods that should and would cease to exist if the forces of correction were allowed to express themselves.

As it stands, the bulls are convinced that the Fed is going to "light their fires" – and the result will be that both the economy and the stock market will head higher.

The few remaining bears are convinced that we've seen the highs on the Dow, the S&P and the Nasdaq and that the next major move (which may take time) will be down.

So what's the least expected and perhaps most frustrating forthcoming situation? I think it could be stagflation.





The PTI and A-D both rising impressively and yet the Dow and S&P appear to be locked into trading ranges.

Consider this: The Fed, frantic to avoid a recession or even a "hard landing," is flooding the nation with new money. At the same time, the Fed is preventing both the economy and the stock market from truly correcting (of course, the Nasdaq has corrected, but it's still overpriced).

The Fed's action is already serving **to extend the bear market.** The question is – how long will the Fed be able to hold off the corrective forces of the bear market? Will it be another month, another six months, possibly another few years?

If the Fed is successful in extending or holding off the bear, I believe the market could lapse into a high-level trading range. It's happened before. It could easily happen again.

This could be very frustrating for US investors. Remember, in today's market there are really no dividends to speak of, which means no income from stocks. Yet for years investors overlooked the lack of dividends because they were generating capital gains.

With stagflation in the saddle, we'd have a world with no dividend income and no capital gains. But what we would have -- would it be climbing utility bills, climbing food bills, climbing rent bills, and still-high medical and education bills. In other words, due to the flood of new money created by the Fed, prices might continue to climb – but income would not rise in tandum. Personally, I believe that there is a good chance that this is what we face

A second situation that I foresee **is rising frustration with the Fed.** Frankly, in all my years dealing with the market and the events behind the markets, I've never seen any popular indicator, index, person or idea that wasn't trashed in a matter of time.

The faith in the Fed and Greenspan has now reached almost surreal heights. Somewhere ahead I think that the Fed is going to hit a wall of investors discontent. I believe we're going to see the Fed's popularity take a giant dive. I don't know exactly how or why – but I do think it's coming.

Nobody, nothing, on Wall Street retains its popularity. The greater the faith and following – the bigger the fall. It's nasty, it's unfair, but it's part and parcel of the history of Wall Street. On Wall Street things change. And when they change, they often change big-time.

Stock buyers today should be aware that the price/earnings on the S&P is now 25 while the dividend yield is 1.19%. Statistics show that when the P/E is 22, the median income for the coming ten years is 5%.

The great fortunes in the stock market have generally been made by those who accumulated stocks when they were selling at bargain prices. As an example, when price/earning ratios were under 10, the median return for stocks over the following ten years was 16.9%.

In October 1974 the P/E for the S&P was 6.8. In March 1978 it was 8.0. In August 1982 its was 6.7.

On January, 2001 it was 25.6.

DIVIDENDS: Subscribers know that I am a firm believer in buying stocks which pay dividends. Dividends allow you to compound. The following is from *Investment Quality Trends* of La Jolla (858 459-3818), also firm believers in dividends.

"Dividends tell a true story about the financial strength of a company. Unlike earnings, which can be the product of creative accounting, dividends are REAL money, not just figures on a balance sheet. Dividends are paid out of profits. While there are times when a company may dip into cash flow to meet a dividend payment, unless earnings and profits soon are forthcoming, the rescued dividends will be reduced or omitted.

"Dividends tell us something about a company and its management that no amount of public relations can disguise. When a dividend is paid, you KNOW that your company has excess capital. When a dividend is increased, you KNOW

that your company has had a good year. When a dividend is lowered, you KNOW that your company is in trouble. And when the dividend is increased year after year, you KNOW that your company is making profitable progress.

"Dividends are the cornerstone of blue chip quality. Responsible companies are willing to share the wealth with the stockholders. They are proud of their dividend histories. They aim to increase and extend them."

NEW DOW STUDIES: *Investment Quality Trends* here in La Jolla (7440 Girard Ave, La Jolla, CA 92037) in their latest bulletin provides some items that require real thought. They note that with the recent inclusion of new tech stocks into the D-J Industrials, the yield on the Dow has been reduced dramatically.

Until recently, no stock without a dividend has ever been included in the Dow. In November, 1999, for the first time in history, two Nasdaq stocks were included in the Dow – Microsoft and Intel. Also, for the first time in history, a stock that pays no dividend was included in the Dow -- that stock was Microsoft. "Several high-yielding stocks like Texaco and Woolworth were replaced by stocks that pay only nominal dividends, stocks such as Home Depot ($0.16) and Disney ($0.21). And although Intel does pay a dividend, the dividend amounts to only $0.08 annually."

So with inclusion of the above plus the addition of Hewlet Packard and Wal-Mart (both of which pay only nominal dividends) the dividend yield for the Dow has been changed dramatically.

Classically, over the decades whenever the Dow yield was as high as 6% or more, that represented "great value" for blue chips stocks; it also indicated that the Dow and the market in general was at or near a major bottom.

Conversely, whenever the Dow rose to the point where it yielded around 3%, that was an indication that the Dow and the stock market in general was at, or very close to, a bull market top.

But what about the Dow now, with the inclusion of so many new stocks that pay little or no dividends? *Investment Quality Trends* believes that the perimeters of the Dow yield should be changed.

They believe that a Dow yield of 1.5% indicates an overvalued Dow and a market that is at or close to a bull market top. They also believe that a Dow yield of around 3% indicates a Dow that is at or near a bear market bottom – in other words, a market that represents great values.

I guess I disagree. I don't care what or how Dow Jones changes the Dow. When the Dow advances to the point where it yields 3%, I don't believe that represents "great value." I believe it is simply a product of many years of a bull market. During those many years, investors were satisfied with a low to zero-dividend policy because stocks were generally rising and they were generating capital gains.

I believe as the bear market progresses, that wildly-bullish sentiment will change. When it changes, when stocks no longer provide capital gains, investors will start demanding some kind of return on their investment. The return will have to be dividends.

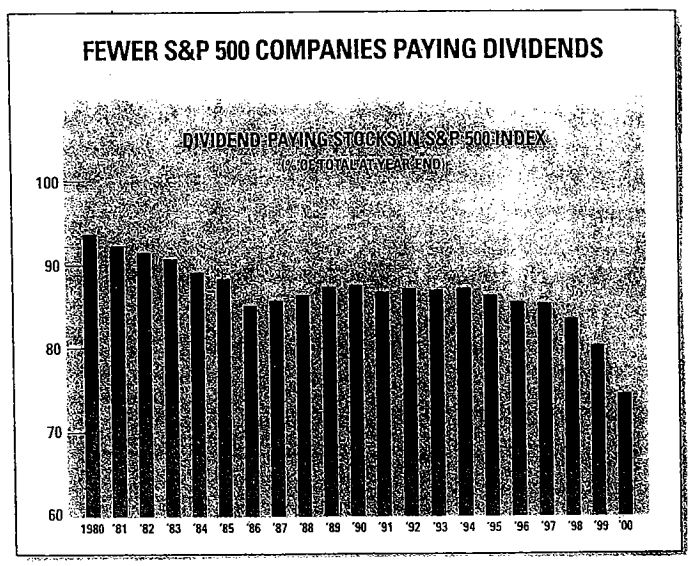
Over the decades, dividends have provided roughly 40% to sometimes 50% of the total return on common stocks. Take away the dividends and you have to depend almost entirely on higher prices – capital gains.

In my opinion, as this bear market moves on, there will be increasing scepticism towards stocks that pay tiny dividends or no dividends at all.

After all, if you own a CSCO or a MSFT or an INTC and you are holding these stocks as they sink and on top of that you receive nothing in the way of a return, how long can that go on?

This graph of the S&P shows the trend of dividend payments year by year since 1980. You can see what has been happening. And the companies got away with it because a bull market was in force and stocks in general were rising.

Once it dawns on investors that the bull market is history, the no-dividend policy, I believe, is going to come into serious question. And stocks that pay no dividends will suffer accordingly.


FEWER S&P 500 COMPANIES PAYING DIVIDENDS
DIVIDEND-PAYING STOCKS IN S&P 500 INDEX
(% OF TOTAL AT YEAR END)
100
90
80
70
60
1980 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00

BACK ON THE "Q": People keep asking or wondering whether this can possibly be a "really big" bear market. One way of gauging the possibilities is via the Q ratio.

The Q ratio was invented by Yale emeritus professor James Tobin, who won the Nobel prize for economics for his work in this area back in 1981.

The Q ratio is fascinating because it has successfully predicted every MAJOR market top of the last century. The Q is not useful most of the time, but it is useful when it measures EXTREMES.

The Q ratio measures two different estimates of the value of US corporations. The first value shows what Wall Street says US corporations are worth; it shows their values simply through market price.

The second value shows their fundamental worth, or what their physical and financial assets are worth.

The ratio of these two valuations is what makes up the Q ratio.

Currently, the Q ratio runs about 150% of replacement values. This is 2 ½ times the average level of the Q ratio over the last century. As a comparison, in the late 1920s and in 1966 and in the early 1970s the ratio was a little better than 120%.

In other words, the Q ratio is higher now than it was at three important market tops.

To get the Q ratio back to real value the stock market could fall as much as 50-60% or the Dow could drop back to the 4000 area.

Dividends on the Dow are now roughly $170. Suppose the Dow was to sell at a yield of 6%, which is where many bear markets have ended. This would take the Dow to below 3000 (and this is assuming no dividend cuts).

Sounds impossible. But this is not far below where the Q ratio says the Dow could go. So Dow 3000 to 4000 would be the area that both a 6% Dow yield and the Q ratio says we could go if this bear market evolves into a major bear market.

The Russell motto – "Hope for the best and be prepared for the worst."

NOTES & QUOTES: *Fortune* magazine (Feb. 5) published a list of ratings from the top 10 brokerage houses. Here's how it ran.

Merrill Lynch 940 buys and 7 sells.
Salomon Smith Barney 856 buys and 4 sells.
Credit Suisse 791 buys and 9 sells.
Goldman Sachs 780 buys and 4 sells.
UBS Warburg 696 buys and 8 sells.
Morgan Stanley 670 buys and 0 sells.
Lehman Bros. 705 buys and 8 sells.
Bank of America Securities 557 buys and 6 sells.
Deutsche Bank Alex Brown 513 buys and 9 sells.
Bear Stearns 525 buys and 2 sells.

The whole thing is so flagrant that it made the TV show, "60 Minutes" a few weeks ago. Skepticism towards Wall Street analysts has never been greater.

* *

China, with the world's largest population, has been dealing with deflation for 23 consecutive months. In the face of huge debts and state projects going bankrupt, the Chinese people (like the Japanese) are afraid to spend. In fact, their savings rate is a huge 42%. They are literally hoarding money. What would make the Chinese people take their money out of the banks and spend it? Possibly monetary devaluation, the deliberate act of reducing the purchasing power of their money.

But if China devalued, the act would almost surely set off a series of competitive devaluations throughout Asia.

* *

The March yen is now about 116 to the dollar. The Japanese don't want a yen under 110 to the dollar (at that price Japanese exporters can make money.) The Japanese want a "cheap" yen. But Japan's neighbors will be angry at any attempt to cheapen the yen and thereby make Japanese exports more competitive.

* *

The laser is a fabulous invention; it's used in everything from surgery to super-market bar-code readers to photocopiers. In a new book, "Laser," the author states that the laser was invented by Gordon Gould, an obscure physics graduate student from Columbia University. The whole laser concept first occurred to Gould one November night in 1957. Gould wrote down his laser ideas in a notebook which he had notarized at a neighborhood candy store. He then dropped out of Columbia and joined Technical Research Group, a tiny high-tech outfit that lived on contracts from the Defense Department. With Gould's help, TRG made a proposal to the Defense Department's Advanced Research Department's Agency.TRG landed a million-dollar contract to develop the laser for military purposes.

But Gould had earlier activities as a Communist sympathizer, and he was barred from working on his own project. Meanwhile, two other scientists published a path-breaking review in *Physical Review* regarding their laser ideas in December 1958. Physicists at Hughes Aircraft and Bell Labs made the first operating lasers in 1960. Meanwhile, Gould began a decades-long battle to regain some of the recognition and rewards for what he insisted was his invention. Gould eventually won his case against Control Laser Corp. of Orlando, in 1987, thereby vindicating his claims and making him rich.

* *

I continue to watch the trend of the **Dollar Index**. After topping out on October 26 at a value of 118.72, the March Dollar Index smashed to a low of 108.04 on January 1. Since then the Dollar Index has been advancing in a weak rally to the 112 level.

* *

In his speech of last week, Greenspan "talked up" both the stock market and the economy and predicted "no recession." It's obvious that Greenspan would like both the stock market and the dollar to hold up. If Greenspan hints that he is going to lower rates aggressively, the dollar would be weakened, and the last thing Greenspan wants to see is a swooning dollar. Thus Greenspan is "talking the talk," but I believe he will be very wary of taking interest rates down "too far."

As the Fed lowers interest rates, dollar-denominated securities become less attractive to foreign holders. At some point the urge to sell US securities would become overwhelming. Currently, foreigners hold over $600 billion of negotiable US securities.

* *

Old timers may remember **Barron's Confidence Index.** This Index enjoyed a huge following back in the '70s, but it's now largely forgotten. The Confidence Index or CI is a **ratio** of the average yield to maturity of the Best-Grade bond list compared to the average yield to maturity of the intermediate-grade bond list. A rise in the CI indicates rising confidence on the part of investors while a declining CI indicates sinking confidence.

Joe Granville popularized this Index on the thesis that its movement preceded movements by stocks by two to four months. The CI has been fluctuating in the 90s during the last year or so, but around November of last year the CI dropped into the high 80s. But on January 29 the CI sank to 88.1. Last week the CI declined to a new low of **87.1.** This suggests that the stock market could be facing trouble two to four months from now. It also indicates that the confidence of bond buyers is declining.

* *

In recent years, retail organizations expanded at a tremendous rate, with many retailers doubling and tripling the number of stores they owned.

Now the correction in retail has come. Some retailers are filing for bankruptcy, others are closing stores, and some are just plain closing. One place where you can see the retail troubles is in bank loans. For instance, one bank that owns part of a loan to Warnaco, recently offered to sell the loan to any bidder for 55 cents on the dollar. The private market for the bank debt of Revlon has sunk beneath 90 cents on the dollar. In the past four months alone, Moody's has downgraded the debt of both Saks and ShopKo stores from investment quality to junk. Dillard's and JC Penney are having their credit reviewed by Moody's. During the second half of the nineties, retailers increased their total footage by nearly a billion square feet or almost 10%. That, it turns out, was too much.

* *

Mad cow disease is devastating the beef industry in Europe. Huge inventories of beef are building up in Europe. As I see it, it's only a matter of time before the mad cow scare hits the US. One reason it hasn't, so far, is that meat inspection is very sparing in the US, nothing like it is in Europe. When the first evidence of mad cow disease is discovered in the US, the fear will be on. As I said, I believe it's only a matter of time.

• *

5,000 - I now have 5,000 subscribers who tune in daily to the Internet reports and less than 2,000 who receive the Letter but are not on the Internet.

The Letter is a lot of work to write, and there's always the temptation to drop the Letter, save all that postage and printing costs, and just offer the daily Internet reports.

But I don't want to do that, even though it would save me money and time. I've been writing the Letter since mid-1958, and it's sort of a sentimental project for me. Also, most of those who are not on the net are either older people (many have been with me decades) or else they are people who just don't like or won't deal with computers.

What should I do? I'll just keep doing what I've been doing. Frankly, the daily site is a good deal easier to do than the Letter. But I have a soft spot for those people who can or will only keep in touch with me via the Letter. A secret - my sister who is four years younger than I am) tells me that she just won't mess with computers. She reads the Letter faithfully, but there's just no way that I can get her to buy a computer. I obviously have a lot of subscribers that have the same prejudice (or fear) of computers. Conclusion: I'll keep writing the Letter.

Debt smothers young Americans

For many living in a world of easy credit, digging out of debt can become a way of life: 18- to 35-year-olds often live paycheck to paycheck, using credit for restaurant meals and high-tech toys. A new study says the average undergrad now owes $2,748 on credit cards.

Undergraduates pile on credit cards and debt

1998 2000

Have credit card: 67% 78%

Have 4 or more cards: 27% 32%

Avg. credit card debt: $1,879 $2,748

Source: Nellie Mae

By Robert W. Abrens, USA TODAY

By Christine Dugas
USA TODAY

As a freshman at the University of Houston in 1995, Jennifer Massey signed up for a credit card and got a free T-shirt. A year later, she had piled up about $20,000 in debt on 14 credit cards.

Cover story

Paige Hall, 34, returned from her honeymoon in 1997 to find herself laid off from her job at a mortgage company in Atlanta. She was out of

By Michael Schwarz, USA TODAY

* *

The page 5 article from *USA Today* (Feb. 13) talks about young Americans in debt. Of course, we know that Americans of all ages are heavily in debt. Which is why the Fed is so frightened of a recession or a major stock market decline which would serve to throw the nation into recession.

The other Fed fear is of Americans cutting back on their spending and starting to pay off debt – while they save. Easy money and a lot of it courtesy of the Fed printing machine got the nation into this fix. Ultimate liquidation will get us out of the fix – the hard way.

INVESTMENT POSITION: This isn't for everyone, but it's what I'm doing. I'm buying high-grade municipal bonds and simply compounding, meaning that as the interest comes in I'm buying more bonds.

I'll probably keep doing this until such time as I think the bear market has hit bottom or until stocks become attractive on a dividend basis.

It's counter-intuitive, but in a bond program, once you've established your basic or initial position, you really want the bond market to head lower. The reason is simple: the bonds you own will all mature at par or 1000 so you don't care where they are at any given time. But when the bond market heads lower, interest rates move higher, meaning that when you reinvest you're receiving more income for each dollar you spend.

When you buy bonds, you should look at the process as buying income. Safety then becomes a major consideration. It's also best to buy discounted bonds: these are bonds that were issued when rates were lower, but as rates rose these bonds sunk below their issuance price. When you buy a discounted bond, the bond will tend to move towards 1000 until at maturity time the bond will be at 1000. That is, unless it's called. When a discounted bond is called, it's almost always called at a higher price than that which you paid.

So there are usually three rates of interest on a bond: (1) The current rate, (2) the rate if the bond is held to maturity, and (3) the rate if the bond is called.

The important thing to remember is that if you buy bonds, not as a speculation but as part of an on-going program, you have to buy quality bonds and you have to understand the concept of compounding.

When you buy bonds think of it as buying quality income at the best price possible. And when you buy income you have to think of it as part of a compounding process.

But in general, you don't buy bonds for appreciation, you buy them for safety and total return. The best time to buy bonds is when they are very competitive with stocks or when stocks are so expensive that they make no sense as long-term holdings.

I would avoid bond funds. There is no guarantee that losses in a bond fund will ever be recouped, simply because bond funds, unlike individual bonds, have no maturity date. In other words, bond funds do not pay off at par.

LATE NOTES: The tax cut, I believe, is fading in importance. Bush wants a $1.6 trillion tax cut over ten years to be retroactive to January 1. The Democrats want less. They'll argue, they'll talk, and in the end they'll compromise. By the time the tax cut is settled it won't amount to much for lower-income families and it will be a non-event for higher income families.

The elimination of the estate tax is being put on the back-burner. The Democrats and some Republicans complain that elimination or even cutting the estate tax will hurt charities. So not much will be gained here either.

In the meantime, Clinton goes out in a blaze of sleaze. Walking off with White house gifts and furniture, pardoning criminals, even Clinton's closest fans are aghast and leading Democrats are speechless and dumbfounded. The Clinton legacy is going down the drain in a torrent of unbelievable immorality. Students of the presidency have never seen anything like it. This from the couple who scolded us about the '80s, calling them "the decade of greed."

The stock market seems locked into a trading range with the Dow below where it was 21 months ago and the S&P below where it was 22 months ago. In the interim, many stocks have been crushed and the average investor is doing well to have stayed even.

Most people do not understand the basic difference between holding expensive stocks and holding bonds. When a stock like Cisco loses two-thirds of its value, there is no guarantee that you'll ever break even on your original purchase. The stocks pays no dividend so there's no guaranteed return for waiting.

When a (high-grade or insured) bond declines, you continue to receive interest on the bond, and as time passes, you move progressively nearer to the time when the bond will mature and pay off at par (1000). The problem with bonds is that appreciation is limited unless you are smart enough or lucky enough to buy the bonds when rates are high and when rates are on the edge of a major decline.

I would like all subscribers who have access to the Internet to turn to www.pimco.com and read the great piece by Bill Gross entitled "Investment Outlook."

NEXT MAILING: March 14, 2001